

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **201147010**

Release Date: 11/25/2011

Index Number: 2601.03-01, 2501.00-00,
2036.00-00, 2038.00-00

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B04

PLR-107948-11

Date: AUGUST 17, 2011

RE:

LEGEND:

Settlor
Trust

State
Court
Date 1
Date 2
Date 3
Date 4

Scrivener

Child A

Child B

Child C

Settlement Agreement

Descendants' Trust

Citation 1

Citation 2

Citation 3

Dear :

This letter responds to your authorized representative's letter dated February 22, 2011, requesting gift, estate, and generation-skipping transfer (GST) tax rulings with respect to the proposed reformation of Trust.

The facts submitted are as follows:

On Date 1, prior to September 25, 1985, Settlor created Trust, an irrevocable trust, for the benefit of his children and more remote descendants. Settlor made a gift of assets to Trust. At the time Trust was created, Settlor had two minor children, Child A and Child B. Settlor and two other individuals (neither of whom made any transfers to or have any beneficial interest in Trust) were named as Trustees of Trust.

Prior to Date 1, Settlor had directed his attorney ("Scrivener") to prepare a trust that would be exempt from transfer taxes, that would primarily benefit his children, and of which he could be a co-trustee. Settlor and Scrivener discussed a number of options to achieve Settlor's tax planning goals and his goal to benefit his children. While attempting to implement Settlor's directives, Scrivener mistakenly omitted provisions (the "Omitted Distributive Provisions") that would permit Trustees to make distributions from Trust to any beneficiaries during Settlor's lifetime. When Settlor executed Trust, he did not realize that Trust did not contain the Omitted Distributive Provisions.

The dispositive terms of Trust, as drafted, provide that no distributions may be made from Trust to any person during Settlor's lifetime. After Settlor's death and until his youngest living child reaches age 25, Trustees may distribute so much of Trust's net income or principal as they deem necessary or proper for any of Settlor's descendants' "comfortable maintenance, support and education" taking into consideration other resources available to such beneficiaries.

The Trust further provides, that upon the earliest date after Settlor's death that no surviving child of Settlor is under age 25 (the "Division Date"), Trust will be divided on a per stirpes basis into separate trusts for each of Settlor's living children and the descendants of a deceased child of Settlor. Each such beneficiary is the sole beneficiary of such separate trust. Prior to attaining age 30, the beneficiary of each such trust may receive discretionary income or principal as the Trustees deem necessary or proper for his or her comfortable maintenance, support and education, taking into consideration other resources available to such beneficiary. After attaining age 30, such beneficiary receives one-third of the assets of his or her trust outright and continues to receive discretionary principal plus mandatory income from the remainder. Upon attaining age 35, a beneficiary receives one-half of the remaining principal with the remaining one-half distributed at age 40. Trust limits the assets that can be distributed to cash or "Liquid Assets," as such term is defined in Trust. If at any time there are insufficient amounts of cash or Liquid Assets to make a distribution provided for by Trust, then the Trustees are required to make such distribution only when cash or Liquid Assets become available. If a beneficiary dies prior to termination of his or her

trust, the assets pass to such beneficiary's descendants per stirpes, or if none, to Settlor's descendants per stirpes, or if none, to Settlor's heirs-at-law.

Finally, Trust contains a provision expressing Settlor's intent that it be administered primarily for the benefit of his children. Article SEVENTH of the Indenture of Trust, specifically states that "[s]ince the primary concern of Settlor is for the welfare of the immediate beneficiaries of the trust rather than for the remote beneficiaries Settlor directs the Trustees to administer the trust estate from time to time to the best advantage of the beneficiary or beneficiaries then entitled to enjoy the benefits of the trust estate, even though the result might be detrimental to subsequent beneficiaries."

After realizing that the Omitted Distributive Provisions were not included in Trust, on Date 2, Child A and Child B (now adults) filed a petition with Court to reform Trust. On Date 2, in addition to Child A and Child B, Settlor had one minor child, Child C, and no additional descendants. Child A and Child B requested that the Court reform Trust to correct the mistake of Scrivener and to effectuate the intent of Settlor that Trust could make distributions to his lineal descendants during his lifetime. Settlor, pursuant to an affidavit, stated that he told Scrivener that he wanted Trust to benefit Settlor's children during Settlor's lifetime. Scrivener, pursuant to an affidavit, stated that Settlor intended that the trustees of Trust should be able to make distributions to Settlor's children during Settlor's lifetime.

In the reformation proceeding, Court appointed guardians *ad litem* for Child C and for the unborn beneficiaries of Trust. The guardian *ad litem* for Settlor's minor child supported the reformation after obtaining affidavits from the Trustees that they would continue to comply with their duty of impartiality under the law of State in making distribution decisions. The guardian *ad litem* for the unborn beneficiaries reviewed the facts and law cited by Child A and Child B and performed his own analysis of the law of State on the issue of reformation and did not object to it on State law grounds. However, the guardian *ad litem* for the unborn beneficiaries was concerned that the reformation could negatively affect his wards. After numerous discussions with counsel for the other parties, he agreed that he would approve the reformation of Trust only if the interests of his wards were taken into account.

The guardian *ad litem* for the unborn beneficiaries then analyzed the effect of the reformation on the interests of his wards and determined that the primary risk to unborn beneficiaries is that they may inherit a reduced share of Trust due to accelerated (during Settlor's lifetime rather than only after his death) distributions to Settlor's children if Settlor's child (who is their parent) were to die prior to reaching age 40. Based on his concern regarding this risk, the guardian *ad litem* for the unborn beneficiaries indicated that he would object to the reformation.

To determine the likelihood of this scenario, the unborn beneficiaries' guardian *ad litem* requested that the Trustees eligible to participate in discretionary distribution

decisions prepare affidavits regarding their understanding of Trust's distribution standard and their views regarding the likely needs of the beneficiaries. He then hired an actuary to evaluate the effects of the reformation of Trust on the interests of unborn beneficiaries, taking the above-described Trustees' statements into account. The actuary calculated a "Grandchildren Neutral Amount," an amount that the unborn lineal descendants of Settlor must receive for each distribution to Settlor's children from Trust during Settlor's lifetime for the reformation to have a neutral effect as to such beneficiaries.

The guardian *ad litem* for the unborn beneficiaries requested that his wards be compensated for any amount that they were disadvantaged by the reformation of Trust, and suggested that Settlor create a new trust in order to accomplish this.

After discussions and negotiations, Settlor, Trustees, Child A and Child B, and the guardians *ad litem* for Child C and the unborn beneficiaries agreed to the terms of a Settlement Agreement that would reform Trust and address the concerns of the guardian *ad litem* for the unborn beneficiaries.

The parties agreed that such Settlement Agreement would be signed upon Court approval of both its terms and the reformation of Trust, and would be contingent upon the receipt of a private letter ruling that the reformation of Trust pursuant to the Settlement Agreement would not result in adverse gift, estate, or GST tax consequences.

Under the Settlement Agreement, the parties agreed that Trust would be reformed so that it effectuated the intent of Settlor when he executed Trust, so that Trust would permit distributions to his descendants during his lifetime.

Specifically, Trust would be reformed to eliminate the language that did not permit distributions of income or principal during the lifetime of Settlor, and instead provide that until the Division Date, as to income: "Trustees shall pay to or use for the benefit of the Settlor's lineal descendants then living as much of the net income derived from the trust estate as Trustees may deem necessary or proper for the comfortable maintenance, support and education of the Settlor's said lineal descendants, taking into consideration any other resources available to the Settlor's said lineal descendants of which the Trustees have actual knowledge, in whatever proportions the Trustees shall determine and direct." As to principal, if "the Trustees should conclude that further funds are needed for the comfortable maintenance, support or education of any lineal descendant of the Settlor, taking into consideration any other resources available to such lineal descendants of which the Trustees shall have actual knowledge, the Trustees shall be authorized and empowered to pay to or use for the benefit of such lineal descendants such sum or sums out of the Liquid Assets then constituting the principal of the trust estate as the Trustees may deem necessary. Any sums so paid to or used for the benefit of any beneficiary shall not be deemed to be advancements

against any payments of net income which he or she may thereafter become entitled to receive.”

To address the concern of the guardian *ad litem* for Child C that his ward’s interests be given equal consideration in distribution decisions, the Settlement Agreement confirms that the Trustees will comply with their duty of impartiality under State law by giving Child C’s interests the same consideration that is given to the interests of the other beneficiaries when making distribution decisions.

To settle the claims of the guardian *ad litem* for the unborn beneficiaries, Settlor agreed to create a separate trust, the “Descendants’ Trust,” for the benefit of Settlor’s lineal descendants other than his children. Under the agreement, Settlor will contribute money each year in which the Trustees make a distribution from Trust to Settlor’s children. The amount that Settlor will contribute will be 7.5 percent of the amount of each Trust distribution made to his children, and will be reduced by the amount of any Trust distribution to Settlor’s lineal descendants other than his children during such year. The trustees of the Descendants’ Trust would be able to make distributions to its beneficiaries under the same standards as Trust.

On Date 3, Child A and Child B submitted a Petition for Court Approval of Settlement Agreement and a supporting Memorandum of Law to Court. Court was advised of the facts supporting the reformation and provided with an analysis of the clear and convincing evidence standard for reformation under the law of State. On Date 4, Court approved the Settlement Agreement (a) finding the terms of the Settlement Agreement to be in the best interests of Trust and its beneficiaries, the provisions thereof to be fair, consistent with the intent of Settlor of Trust, the result of arms-length negotiations, and either consistent with the terms of Trust or a reasonable settlement of bona-fide disputes or claims under the law of State, (b) authorizing and directing the guardians *ad litem* for Child C and unborn beneficiaries of Trust to sign the Settlement Agreement on behalf of their wards and binding Child C and unborn beneficiaries to the terms of the Settlement Agreement, (c) reforming Trust to reflect Settlor’s original intent as described in the Settlement Agreement, and (d) declaring that the reformation of Trust was contingent upon obtaining a private letter ruling from the Internal Revenue Service regarding the gift, estate, and GST tax implications of the reformation.

You have requested the following rulings:

1. Reformation of Trust pursuant to the Settlement Agreement will not cause Trust to lose its GST exempt status.
2. Reformation of Trust pursuant to the Settlement Agreement will not cause the assets of Trust to be includible in Settlor’s estate for estate tax purposes under § 2036 or 2038.

3. Reformation of Trust pursuant to the Settlement Agreement will not cause the assets of Trust to be considered a gift from Settlor to Trust for gift tax purposes.
4. Reformation of Trust pursuant to the Settlement Agreement will not cause the assets of Trust to be considered a gift from one beneficiary to another beneficiary for gift tax purposes.

LAW AND ANALYSIS

Ruling 1

Section 2601 of the Internal Revenue Code imposes a tax on every generation-skipping transfer (GST), which is defined under § 2611 as a taxable distribution, a taxable termination, and a direct skip.

Under § 1433 of the Tax Reform Act of 1986 (Act), the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, provided no additions (actual or constructive) were made to the trust after that date.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax under § 26.2601-1(b) will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to chapter 13, if (1) the settlement is the product of arm's length negotiations; and (2) the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

Section 26.2601-1(b)(4)(i)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the GST provisions if: (1) the judicial action involves a bona fide issue; and (2) the construction is consistent with applicable state law that would be applied by the highest court of the state.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A modification of an exempt trust will result in a shift in a beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a generation-skipping transfer or the creation of a new generation-skipping transfer. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust.

Section 26.2601-1(b)(4)(i)(E), Example 3 considers a situation where, in 1980, Grantor established an irrevocable trust for the benefit of Grantor's children, A and B, and their issue. The trust is to terminate on the death of the last to die of A and B, at which time the principal is to be distributed to their issue. However, the provision governing the termination of the trust is ambiguous regarding whether the trust principal is to be distributed per stirpes, only to the children of A and B, or per capita among the children, grandchildren, and more remote issue of A and B. In 2002, the trustee files a construction suit with the appropriate local court to resolve the ambiguity. The court issues an order construing the instrument to provide for per capita distributions to the children, grandchildren, and more remote issue of A and B living at the time the trust terminates. The court's construction resolves a bona fide issue regarding the proper interpretation of the instrument and is consistent with applicable state law as it would be interpreted by the highest court of the state. Therefore, the trust will not be subject to the GST tax.

In Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the Court considered whether a state trial court's characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Court concluded that the decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. If there is no decision by that court, then the federal authority must apply what it

finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

The purpose of reformation is to "correct the mistakes of a scrivener incorporated into a contract, deed, or other instrument... ." Citation 1. Courts in State will grant reformation when an actual agreement of the parties exists other than the one that was expressed in the writing at the time a document was executed. Citation 2. However, to sustain the burden of proving that an instrument was executed by mistake, the evidence must be clear and convincing. Citation 3. Thus, courts in State will grant reformation when it can be shown by clear and convincing evidence that provisions were inserted or omitted because of a mutual or unilateral mistake and that, as written, the instrument does not truly reflect Settlor's desires and intention at the time of execution and delivery.

In this case, an examination of the relevant trust instruments, affidavits, and representations of the parties indicate that Settlor intended that Trustees (other than himself) have the discretion during his lifetime to make distributions of income and principal to his children, as the current beneficiaries of Trust, for their comfortable maintenance, support, and education. This intent was not carried out in the Trust agreement due to scrivener's error. Accordingly, based on the facts presented and the representations made, we conclude that the reformation of Trust is consistent with applicable State law that would be applied in the highest court of State. Thus, we rule that the proposed reformation of Trust pursuant to the Settlement Agreement will not cause Trust to lose its exempt status for purposes of the GST tax.

Ruling 2

Section 2036 provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death -- (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 2038(a)(1) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the

decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

In order for §§ 2036 and 2038 to apply, the decedent must have made a transfer of property of any interest therein (except in the case of a bona fide sale for adequate and full consideration in money or money's worth) under which the decedent retained an interest in, or power over, the income or corpus of the transferred property.

In this case, an examination of the relevant trust instruments, affidavits, and representations of the parties indicate that certain provisions, resulting from scrivener's error, were contrary to the intent of the Settlor. The proposed reformation does not constitute an exercise by Settlor of any right to an interest in Trust or control over Trust property. The purpose of the reformation is to correct the scrivener's error, not to alter or modify the trust instrument. Additionally, the creation and funding of the Descendants' Trust is an obligation of the Settlor that is separate and distinct from Trust, and would not render Trust's assets subject to § 2036 or § 2038. Accordingly, based on the facts presented and the representations made, we conclude that the reformation of Trust pursuant to the Settlement Agreement will not cause the assets of Trust to be includible in Settlor's estate for estate tax purposes under § 2036 or 2038.

Rulings 3 and 4

Section 2501(a) imposes a gift tax for each calendar year on the transfer of property by gift during the year by an individual.

Section 2511 provides that the gift tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(a) provides that if the gift is made in property, the value thereof at the date of the gift is considered the amount of the gift.

Section 2512(b) provides that where property is transferred for less than an adequate consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration is deemed a gift.

In this case, an examination of the relevant trust instruments, affidavits, and representations of the parties indicate that certain provisions, resulting from scrivener's error, were contrary to the intent of the Settlor. Accordingly, based on the facts presented and the representations made, we conclude that the reformation of Trust pursuant to the Settlement Agreement is consistent with applicable State law that would be applied in the highest court of State. Thus, we rule that the reformation of Trust pursuant to the Settlement Agreement will not cause the assets of Trust to be

considered a gift from Settlor to Trust or a gift from one beneficiary to another beneficiary for gift tax purposes.

In accordance with the Power of Attorney on file with this office, copies of this letter are being sent to your authorized representative.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed or implied concerning the tax consequences of the Descendants' Trust.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

The rulings in this letter pertaining to the federal estate and/or generation-skipping transfer tax apply only to the extent that the relevant sections of the Internal Revenue Code are in effect during the period at issue.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures

Copy for § 6110 purposes
Copy of this letter